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DIPARTIMENTO DI ECONOMIA**

**VARIETIES OF CAPITALISM AND RESPONSES TO THE FINANCIAL
CRISIS: THE EUROPEAN SOCIAL MODEL VERSUS THE US MODEL**

Pasquale Tridico

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Dipartimento di Economia
Università degli Studi Roma Tre
Via Silvio D'Amico, 77 - 00145 Roma
Tel. 0039-06-57335655 fax 0039-06-57335771
E-mail: dip_eco@uniroma3.it



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Varieties of Capitalism and Responses to the Financial Crisis: The European Social Model versus the US Model

Pasquale Tridico¹

University Roma Tre and New York University

tridico@uniroma3.it

Abstract

The objective of this paper is to show how European Union (EU), which employs different varieties of capitalism, and US, which operates based on a competitive capitalist model, are coping with the current economic crisis. Although EU is fragmented and needs to work towards better and deeper integration among member states, the main features of the European Social Model (ESM) allows for a more sustainable recovery and lessens the social costs. A new index was developed in this paper: the Synthetic Vulnerability Index; which shows that the US position is worse than the Eurozone position in terms of recovery from the current crisis and of exposure to further crises. Nevertheless, current financial reforms, both in the US and EU seem to be insufficient and the recent fiscal austerity measures seem to be moving the economies in the wrong direction.

Key words: Financial crisis, Varieties of capitalism, EU social model.

JEL: G01; I31; P51;

¹ Pasquale Tridico is a Fulbright Scholar (2010-11) at the Center for European Studies (CES), New York University (NYU), and Assistant Professor at the *University Roma Tre*, Department of Economics, Rome, Italy. He wishes to thank the Belgium and Luxembourg Fulbright Commission and the US Government for the Fulbright-Schuman fellowship. He is also grateful to Larry Wolff and to all the staff at the CES (where he was Fulbright Visiting Scholar between October 2010 and March 2011) for the support, and to Richard Wolff, Sebastiano Fadda and Paolo Piacentini for their comments. The usual disclaimer applies.

1. Introduction

The economic crisis which started in the financial sector in 2007 is still impacting the real economy, driving a decrease in output and employment levels. The crisis is the biggest since the Great Depression of 1929 and several explanations regarding the financial collapse have already been put forward (Obstfeld and Rogoff, 2009; Krugman, 2008; Greenspan, 2007; Skidelsky, 2009; Whelan, 2010, Semmler et. al, 2010; FMI, 2008; Bini Smaghi, 2008; Caballero et al., 2008; etc).

The crisis has caused worldwide losses amounting to about €3.5 trillion, according to estimates by the International Monetary Fund (IMF). Just to give an idea, that is a bit less than the GDP of China or Japan, twice the GDP UK, or three times the GDP of India (IMF 2009a). It has driven the global recession we are currently struggling against, causing mass unemployment, high social costs and enormous levels of public debt in many countries.

Keynesian policies and fiscal stimuli were implemented both in Europe and the US between 2007 and 2009. Along with these approaches, a great number of bank rescue packages were implemented. However, after the Greek economic crisis in May 2010, governmental policies shifted towards austerity measures, balanced budgets; and as a result, the consensus which had allowed for partial recovery, monetary liquidity, and the bail-out of banks and financial institutions almost dissipated. Fiscal stimuli are no longer unanimously accepted, and the main concerns of industrialized nations became, sovereign debt crises, budget sustainability, and public spending cuts.

The objective of this paper is to show how European Union (EU), which employs different varieties of capitalism, and US, which operates based on a competitive capitalist model, are coping with the current economic crisis. Although EU is fragmented and needs to work towards better and deeper integration among member states, the main features of the European Social Model (ESM) allows for a more sustainable recovery and lessens the social costs. A new index was developed in this paper: the Synthetic Vulnerability Index; which shows that the US position is worse than the Eurozone position in terms of recovery from the current crisis and of exposure to further crises. Nevertheless, current financial reforms, both in the US and EU seem to be insufficient and the recent fiscal austerity measures seem to be moving the economies in the wrong direction.

New levels of government involvement is required in order to keep aggregate demand stable, make full employment possible, and create a transparent financial sector, serving the real economy and encouraging productive investments. The rest of the paper is organized as follows: session 2 introduces briefly the varieties of capitalism argument; session 3 describes the emergence of financialization during post-fordism; session 4 compares the varieties of financial responses to the crisis in US and EU, session 5 analyzes post-crisis differences and tensions between EU and US, builds the Synthetic Vulnerability Index and shows the return of austerity policies, and session 6 concludes the paper.

2. Varieties of Capitalism: Economic Growth and Stability before the Financial-led Growth Regime

In this session I will show that unlike today, during the Fordist period economic systems in advanced economies, particularly in Western Europe, enjoyed, high stability, accumulation, productivity, and economic growth. The basic mechanisms of the Fordist model of accumulation are described in the Figure A1 of the Appendix.

The prevailing model of development during the Fordist era had three characteristics: first, the Taylorist form of labour organization, organized around a semi-skilled workforce within a framework of particular industrial relations; second, the regime of accumulation which allowed for a sharing of the benefits of productivity gains between workers and firm owners; third, the Keynesian Welfare State, which on one hand provided unemployment benefits, allowing people excluded from the Fordist organization to consume, and, on the other supported a high level of aggregate demand. In Europe this model had different executions, but similar results in term of GDP performance and social outcomes. Each European country had its own style of development and built a model of capitalism specific to its needs (Gillingham, 2003).

Generally speaking, countries can be classified according to their type of economic system, which can be characterized by particular institutional forms and macroeconomic factors like domestic competition, role of the state, international trade and openness, monetary forms, etc. Following this approach Amoroso (2003) and Jessop (2002) identified 4 types of economic systems; the Anglo-Saxon model (or competitive capitalism), the Corporative model (Corporative capitalism), the Dirigiste model, and the

Social-Democratic model. To these models, Choi Chonj Ju, (2004) among others (i.e., Yeager, 2004; Qian, 2003; etc), added the current model of the Socialist Markets, represented in particular by China and Vietnam.²

Bruno Amable (2003) narrated a similar story in his book *The Diversity of Modern Capitalism*; proposing five different ideal types of capitalism, taking into consideration five institutional forms (product market competition, wage-labor nexus, financial sector, social protection, and education). He combined the Dirigiste and the Corporative models (forming a Continental European model) and added two new models (the Asian model and the South European model). The Amable (2003) classification is: (1) **the Market Based economy** (the US and the British economies are the closest to this), (2) **Continental European capitalism** (lead by Germany and France), (3) **the Social-Democratic economies** (the Scandinavian economies), (4) **South European capitalism**, and (5) **Asian capitalism**.

The table below summarizes the main characteristics of these socio-economic models, and, in parentheses, lists the notable adherents to the model. The table combines the work of the authors cited above.

For our purposes we will consider the European Social Model as a combination of the German, French, and Scandinavian models.³ These three models have much in common and share similar features, particularly within the financial sector (Sapir, 2005). In general terms, the Eurozone is the aggregation of European countries which fit, to some extent, into the ESM.⁴ The UK and Ireland, although EU members, are considered part of the Competitive Capitalism Model (known also as Anglo-Saxon model or Competitive Market Economies).

² China and Vietnam represent “Socialist Markets” and seem to be the only two countries which embrace such a model. This represents an evolution and is the result of a reform process which started first in China in 1978 and intensified during the 1990s (Yeager, 2004). This process transitioned China and Vietnam from planned economies to “Socialist Market” economies, characterized by forms of property rights which allow: 1) both private and government investment, without complete liberalization, privatization and political pluralism; 2) integration (though modest) into the world economy; and, 3) government control and monitoring of domestic financial markets.

³ This is more in tune the work of Pontusson (2005), and Soskice and Hall (2001).

⁴ Distinct varieties of capitalism exist within the EU and Eurozone. The correspondence between the Eurozone and the ESM may be not perfect, but it is a generalization that we need to use in order to compare the ESM to the US. My argument – that considers the ESM superior to the US model - would be even stronger if I were to only consider the European countries which fit into the ESM, i.e. Austria, Belgium, Finland, France, Germany, the Netherlands, Denmark, Sweden, Slovenia, Hungary, the Czech Republic, plus Norway and Switzerland (these last two are not actually EU members). For a detailed classification of the varieties of capitalism with EU member states, see Table A1 in the Appendix.

Table 1 - Socio-economic Models and their Main Characteristics

Characteristics Models (leader country)	Competition	Economic Regulation	Main Economic Actors	Relationship between Public and Private Actors	International Economic Relation	Taxation	Finance
Anglo-Saxon model (USA, UK, Ireland)	Promotes free competition	Deregulation; withdrawal of the State from the economy	Firms, corporations, markets,	Residual public sector; market- oriented	Global competition	Low taxes, no or little progressive rate	Deregulation and full liberalization; financing for both consumption and investments
Corporative model (Germany)	Balances cooperation and competition	Decentralized	Tripartite structures (business clubs, trade unions, government)	Public- private partnerships	Protection of strategic sectors in an open economy	High taxation to finance welfare state	Developed finance for investment; extensive credit for small firms; limited finance
Dirigiste model (France)	State control; regulated competition	National accumulation and regulation strategy	Private and public sectors	Public- private partnerships under State guide	Protectionism	High Taxes and Collective Recourses	and credit for consumption; financial regulation, transparency and protection of savings;
Social- Democratic model (Scandinavian countries)	State controlled liberalization and competition	Knowledge and innovation as an economic guide for regulation	Public and private firms, ethical corporations	Public- private partnership in order to achieve social cohesion	National actors; moderate free competition; an open economy	High wages; career perspective; high and progressive tax rates	higher taxes on financial corporations

Note: Source: Adaptated from the classifications of Jessop (2002), Amoroso (2003), Amable (2003), and Choi Chonj Ju (2004).

The ESM ensured better economic performance in Europe during the Fordist era of accumulation with respect to US. It was able to deliver better GDP performance for a extended period of time, at least until the end of the 1970s (see figure A2 in appendix). After that, the process of financialization began and a finance-led growth regime took over; the old Fordist regime went into crisis. Reasons for that are different as explained by many scholars (Lipietz 1992; Jessop 2002; Boyer and Saillard 2002)⁵. Under this model of development the EU, or more accurately the Eurozone, was able to outpace the US in social and economic benchmarking areas such as inequality, poverty, public education, and life expectancy thanks to a large public program of social expenditures (as Table A1 and Figure A3 in the Appendix display) . The US, on the contrary, saw slightly faster GDP growth since the 1980s in comparison to the EU, in particular during the past two decades of financialization, but a concerning drop of important social indicators

⁵ In brief, the causes of the Fordist crisis are: a decrease in productivity, poor labor organization, the internationalization of problems through pressure on labor costs, and the resulting decrease in the demand. These are supply side causes, national and international ones, and exogenous to the core of Fordist economic doctrine.

(inequality and poverty). In my opinion, there are at least two reasons that this does not identify a trade-off between efficiency and equality. First, the EU was also growing over the past twenty years (albeit at lower rates than the US economy), not simply maintaining their social indicators. Second, the current financial crisis affected the US very badly in particular, putting into doubt the US model and its vaunted efficiency (Posner, 2009; Wolff, 2009). For these reasons I argue that the ESM is not only able to produce better social performance but also more efficient and sustainable economic development in the long run than the US model.

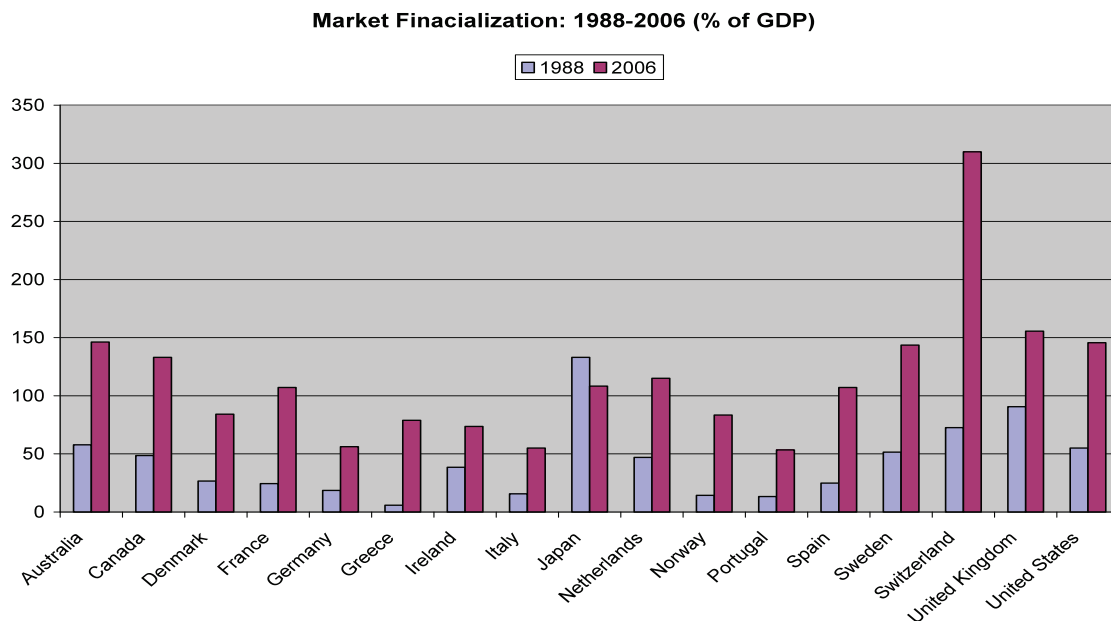
3. Financialization during Post-Fordism

After the demise of Fordism, an unstable new regime of accumulation emerged (Jessop 2002; Boyer and Saillard, 2002). It is characterized by high market financialization, a so-called flexible accumulation regime, and markedly uneven development, with micro-electric, internet, advanced technology, the Knowledge Based Economy driving further cycles of accumulation (Peck and Tickell, 2003; Jessop, 2002). Wages after the 1970s in advanced economies and particularly in US almost stagnated, and profits soared dramatically (Wolff, 2009; EuroMemorandum, 2010). Simultaneously inequality increased sharply (OECD, 2010). In order to keep consumption up, the US maneuvered economic policies: used cheap money which allowed bubbles in the housing sector and private debt soaring; and allowed huge amount of cheap imports from China. This eventually ended up with huge Current Account (CA) deficit: at the eve of the financial crisis in 2007 the US CA deficit was 700 US bn \$ (5% of US GDP), of which, 80% depends on Chinese exports (IMF 2009b). US financed the CA debt issuing US bonds which were bought in turn by Chinese. The issue of global imbalances emerged strongly and it is seen as a co-determinant of the current economic crisis (Obstfeld and Rogoff, 2009).

The shape of regulation during post-fordism changed dramatically to allow for financialization (Lipietz 1992). As Petit (2003: 20) pointed out, with the transition to post-Fordism, institutions are evolving and, in particular, the institutional forms of competition tend to prevail in the emerging regime. On this argument, Boyer (2005) says that in the “hierarchy of the institutional forms,” the one leading the way in the advanced economies during the transition period seems to be the finance sector (2005: 4), which

shapes all other institutions (2005: 18).⁶ The figure below shows, through the value of market capitalization in the stock exchange, as a percentage of GDP, the consistency of the process of financialization in the past two decades⁷.

Figure 1 – Financialization since 1988



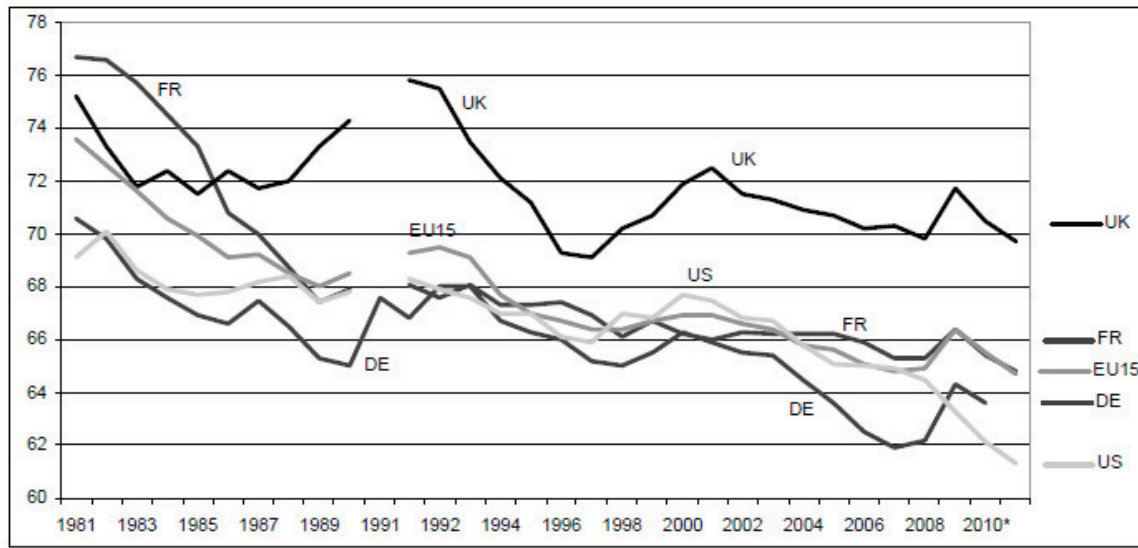
Source: World Bank, 2010, Statistical Indicators (online database)

Moreover, at the political level, the transition to post-Fordism seems to be assisted by a neo-conservatism ruling class. Hence, a comparison with the previous pre-1920s Fordist era seems legitimate, when the liberist model of development was based on an extensive accumulation regime (Aglietta, 1979) with a pressure on labor costs, without government playing a significant role in the economy, without a productivity sharing compromise, and without the Keynesian Welfare State (Basso, 1998). Such a process of financialization was coupled with both an increase of inequality and a decline in the wage shares over the GDP, as the figure below shows.

⁶ However, both, Petit (2003) and Boyer (2005) agree that in the Fordist era, the wage relation was the dominant institutional form and that is what made consistent economic growth possible.

⁷ Market capitalization (also known as market value) is the share price multiplied by the number of shares outstanding. Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at the end of the year. Listed companies do not include investment companies, mutual funds, or other collective investment vehicles.

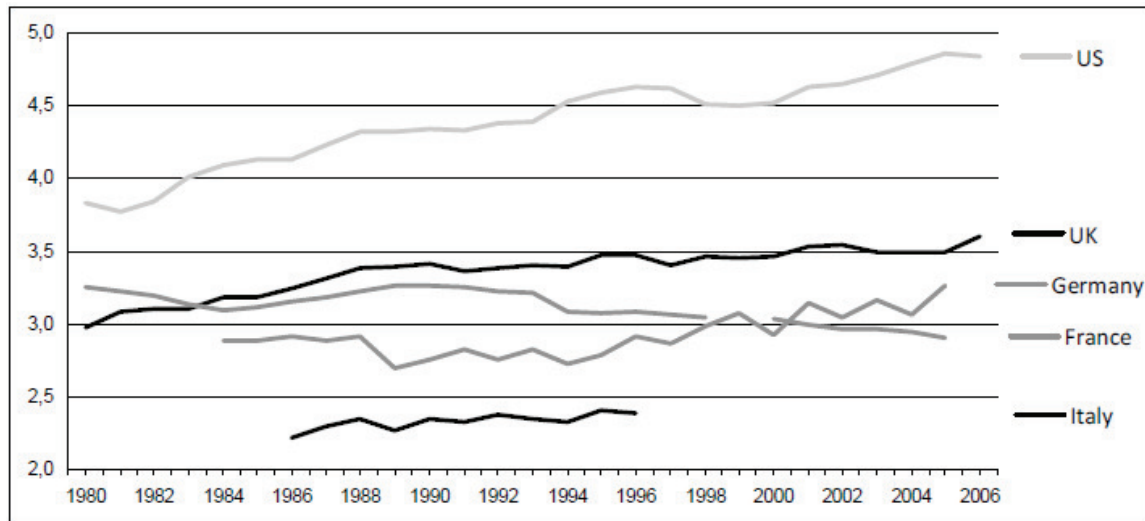
Figure 2 - Wage shares on GDP, selected countries



Source: Euromemorandum 2010

Transition to post-Fordist financial-led regimes is identified in the US with Reaganomics and in the UK with Thatcherism. Jessop (2002) argues that new accumulation strategies emerged during that period. They involved multinational power, international financial discipline, a more authoritarian state, and a sort of popular capitalism. The previous Fordist strategy was replaced by an internationally-oriented and financially aggressive strategy, deregulated and concentrated dually on Wall Street and in the City of London. Reaganomics and Thatcherism were strategies that aimed to restructure the accumulation system through a new regulation system (Peck and Tickell, 1992), at the expense of the social compromise realized after the second World War. The result was uneven development (Peck and Tickell, 1992), with regions and countries divided between financial services and technology-oriented ones, and increasing trends in inequalities and income disparities, in particular in the US and the UK, the countries which were more keen towards financialization, as the figure below shows.

Figure 3 - Wage dispersion, selected countries



Source: Euromemorandum 2010

A similar transition towards post-Fordism, although less severe than in the US and UK, is exhibited by other continental European countries, such as West Germany, France, Italy, and Spain (Jessop, 2002), where severe fiscal and monetary policies, along with industrial restructuring, generated precarious jobs, and higher inequality in particular since the 1990s (Fitoussi, 1992).

These are the roots of the current financial-led model of accumulation and they put in place the mechanisms which helped spur the current crisis. In particular, when the wage-nexus is compressed and labor became extremely flexible, the investment dimension is neglected and replaced by speculative financial investments driven by shareholders interests, and consumption needs to be sustained by fragile financialization and risky financial tools. Failures of the financial-led model of accumulation are evident today because of the crisis, but can be traced to the relatively poor performance of most of the advanced economies during the post-Fordist era, in terms of productivity and GDP growth (see Figure A2 in the Appendix). Petit (2009) refers to the period between 1997 and 2007 as a lost decade of financialized capitalism in terms of productivity gains and growth. Liberalization of finance and globalization did not bring more innovation, since new investments, in which technological progress is usually embedded, lacked substance.

4. Varieties of Responses to the Financial Crisis in the US and EU

The economic crisis of 2007-09 produced painful outcomes in the labor market and society in general, both in the US and in Europe. In short, it caused a global recession, mass unemployment, high social costs, and enormous public debts in many countries (see Figure A4 and Table A3 in the Appendix). In this paragraph I will analyze the responses to the crisis put forward by the US and EU. The US made its response in line with its Competitive Market Economy (CME) model, the EU within the framework of a traditional European Social Model. The latter, however, tends to represent more specifically a Eurozone model (with the exception of Ireland), rather than an EU model since the UK position⁸ more often resembles US regulation.

In general, regarding the financial overhaul, the EU (except UK and Ireland) relies more on the existing institutional governance structures of non-market coordination, while the US, UK, and Ireland rely more on the presumed efficiency of financial markets. It is very interesting to see how, at the April 2009 G20 meeting in London, the different types of socio-economic models and their strategies for recovery were clearly divided: the Franco-Allemande axe, supported by Sarkozy and Merkel, called for all-encompassing state regulation and financial restrictions on hedge-funds and tax havens. The Anglo-Saxon strategy, backed by Brown and Obama, aimed mostly at reaching a consensus in order to provide monetary liquidity to the financial system.

The G20 summit, since its first meeting in Washington, DC in November of 2008, has created conditions to change the global financial structures. However, progress has thus far been made only at very superficial levels, such as tax haven limitations and calling for limitations on executive compensation. An interesting step towards a more democratic and global system of financial governance seems to be the creation of a Financial Stability Board (FSB) which should enhance coordination and improve macro and micro prudential supervision.⁹ The FSB was established to address vulnerabilities and to develop and implement strong regulatory, supervisory, and other policies in the

⁸ For a detailed overview on the British position, see Turner Review (2009) a UK regulatory Report named after Lord Turner, chairman of the United Kingdom's Financial Services Authority, who chaired the review's research group.

⁹ The FSB was established after the 2009 G20 summit in London as a successor to the Financial Stability Forum. The latter was founded by G7 countries in 1999 to promote international financial stability, but has had little impact. The FSB is based in Basel, Switzerland. The chairman of the board is Mario Draghi, president of BankItalia.

interest of financial stability. It includes all G20 major economies, the IMF, WB, the Bank for International Settlements (BIS), and the European Commission. The Secretary of the US Treasury Tim Geithner has described it as a fourth pillar in the architecture of global economic governance, along with IMF, World Bank, and WTO.

That said, within the EU many of differences exist. These differences can be classified in the following ways:

1. Differences between Eurozone and Non-Eurozone nations;
2. Differences between Member States and the central position of the EU Commission;
3. And, above all, differences between the Eurozone (Germany and France in particular) and UK.

Tension and contradiction exists within EU in general, and this is affecting the final outcomes of financial regulation. Compromises, carve-outs, and generic language weaken the new EU regulation (Wahl 2010).

4.1. US Regulation (the “Frank-Dodd Act”)

In July 2010 a financial reform package was adopted in the US, despite the strong opposition of Republicans and Wall Street lobbies.¹⁰ A lot of compromises and carve-outs weakened the original proposal of the White House and Secretary of Treasury Tim Geithner. The important elements of the US reforms can be synthesized into the following 10 points:

1. New requirement for higher capital and liquidity standards for corporations and banks.
2. The famous “Volcker Rule,” which eliminates the dangerous coexistence between investment and commercial banks.
3. Under the Volcker Rule, banks are limited in engaging in proprietary trading.
4. Banks must hold enough capital in reserve to reflect their off-balance sheet, cope with crisis, and avoid illiquidity.

¹⁰ “The Dodd-Frank Wall Street Reform and Consumer Protection Act” was named after the chairmen of the two congressional committees dealing with banking, was signed into law by President Obama on 21 July 2010.

5. A new insolvency regime is introduced, not only for firms but also for banks, and it gives more regulatory and supervisory power to the Treasury.
6. Trade in derivatives is strictly regulated and centralized within a third party clearing authority.
7. Financial firms and hedge funds managers are required to submit swaps to a third authority to back their operations.
8. A new supervision was introduced for Credit Rating Agencies (CRA). The supervisor has the right to examine rating agency operations, data, and methodologies. They can be eliminated from a CRA book if they are shown to have been providing bad ratings for long time, and, most importantly, they are prohibited from advising an issuer and rating that issuer's securities in order to reduce/eliminate conflict of interests.
9. US households and consumers, as well as investors, are better protected under the new laws, with a special agency (Consumer Financial Protection Agency);
10. Stronger supervision and oversight from the Fed, with the creation of a Financial Stability Oversight Council that monitors Wall Street's largest firms and financial institutions.

After the US Frank-Dodd Act, a new supervisory architecture system will be in place, with a major role for the Fed and a stronger advisory role for the Treasury. A *Council of Regulators* is set up to coordinate supervision with the Fed. The Fed wields more prudential supervision over large firms and has an oversight role to play along with other US authorities. This supervision and oversight can be summarized at macro and micro levels.

At the Micro Level: Prudential Supervision in US

Banks are now required to hold more capital and liquidity than before. Large hedge funds have to register with the SEC (*Securities and Exchange Commission*)¹¹ and

¹¹ A government commission created in 1934 by Congress to regulate the securities markets and protect investors. In addition to regulation and protection, it now also monitors corporate takeovers in the U.S. The SEC is composed of five commissioners appointed by the U.S. President and approved by the Senate. The statutes administered by the SEC are designed to promote full public disclosure and to protect the investing public against fraudulent and manipulative practices in the securities markets. Generally, most issues of securities offered in interstate commerce, through the mail or on the internet must be registered with the SEC.

are regulated by it. Under the Volcker Rule, although this was curtailed by Senate with respect to the initial Obama proposal, proprietary trading is limited. This refers to trading stocks, bonds, currencies, commodities, their derivatives, or other financial instruments with the bank's own capital, rather than that of its customers. In general, proprietary trading is considered to be riskier and is associated with more volatile profits (Conzelman et al., 2010: 4). Moreover, the Volcker Rule introduces the separation between commercial and investment banks.¹² Banks are also required not to bet against their own clients. Commercial banks can no longer make speculative bets for their own profits. Banks will be allowed to invest in private equity and hedge funds, but at a level limited to 3% of their capital. At the same time, a new Consumer Financial Protection Agency, housed in the Fed, was set up to provide consumers with services related to mortgage brokers, debt collectors and credit counsellors. New federal banking regulators have been created, also. At the top of this regulatory and supervision hierarchy sits the Fed, which monitors commercial banks and large firms while the SEC monitors the securities market and the Commodity Futures Trading Commission (CFTC) monitors futures. Insurance is monitored at the state level

At the Macro Level: Prudential Supervision in the US

The Fed is empowered as a systemic regulator in its role of market vigilance and monitoring financial institutions at macro level. The new Council of Regulators chaired by the Secretary of Treasury advises the Fed on systemic risks. It has been created as a new insolvency regime for bank and non-bank firm bankruptcies, with special and extended powers of the Treasury. The new financial architecture was reinforced by the introduction of the newly created Financial Stability Oversight Council, which should reduce the deficit in the US for financial institutions and large firms in particular (Conzelman et al., 2010), thanks in part to the new role of the Fed. The Fed will lead the oversight of large financial institutions whose failures could threaten the financial system. At the same time, the Fed's relationship with banks is controlled directly by the US Congress and the Government Accountability Office (GAO). The GAO can audit: 1)

¹² The coexistence was introduced by Clinton, who repealed the Glass-Steagall Act which had ensured the complete separation between commercial banks, which accept deposits, and investment banks, which invest and take risk, prompting the era of super bank and primed the subprime pump. In 1998 sub-prime loans were just 5% of all mortgage lending. In 2008 they were about 30%.

emergency loans made by the Fed (including the ones made after the 2007 financial crisis); 2) the Fed's low-cost loans to banks; and, 3) the Fed's buying and selling of securities to implement interest-rate policy (Conzelman et al., 2010).

4.2. EU Regulation and Responses

The immediate EU responses to the crisis managed by the European Central Bank (ECB) were delayed in comparison to the Fed's reaction, which put immediately huge monetary liquidity back into the system and lowered the interest rates (from 5.25% to 2% in 2008 and to 0.25% in 2010). The ECB did the same, but in a more passive way and with some delay (see Table A3 in the Appendix). Moreover, monetary quantitative easing was less consistent and the interest rate was lowered at a slower pace.¹³ By contrast, the inadequate response of the ECB was followed by a stronger EU regulatory approach to the crisis. This was mainly the result of the recommendations made by the De Larosi re Report (2009)¹⁴, which were adopted by following EU directives and regulations, and by a declaration of support from the EU Commission (2009), the European Council (2009), and the ECOFIN meeting on June 9, 2009. However, as we mentioned above, the EU regulation is weakened by the fragmentation among the EU member states and their different national regulations of financial markets.

At the Micro Level: Prudential Supervision in the EU

The new EU regulations for financial supervision of banks, insurance, and securities created the European System of Financial Supervisors (ESFS), with 3 functional authorities and regulatory powers over banks, insurance, and securities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions (EIOP), and the European Securities Markets Authority (ESMA).¹⁵ This is a compromise between the UK and the EU commission, plus the France-Germany position. The former

¹³ Surprisingly enough on July 2008, two months before the collapse of Lehmann, the ECB increased its interest rate to the high level of 4.5%, even though the crisis had already reached European banks (British Institute *Northern Rocks* was nationalized in February of 2008, and the German IKB went to bankrupt in July of 2007). Since the end of 2008, the interest rate was lowered to 2.5% and then to 1%, although still above the rate of 0.25% set by the Fed.

¹⁴ The De Larosi re Report, published in February 2009, is the result of the research of the High-Level group chaired by Jacques Larosi re, commissioned by the European Commission.

¹⁵ See EU (2009b).

did not want to give the EU strong supervisory power. The latter pushed for a stronger role for EU in the financial supervision. The result is a system of oversight which, at the operational level, remains the responsibility of nations. The role of the EBA, EIOP, and ESMA is to promote cooperation, financial harmony, a common culture of supervision, and common technical standards for monitoring and control¹⁶.

The harshest legislation the EU is introducing concerns OTC derivatives (EU, 2010a), securitizations such as Credit Default Swaps¹⁷ and all kind of Alternative Investment Funds (AIF) like hedge funds, private equity funds, real estate funds, commodity funds, and infrastructure funds (EU, 2009c). The EU has realized that there is much speculative activity among those funds which need to be regulated. The biggest hedge fund was a fraud (Madoff's fund)¹⁸, and many AIF activities rely on opaque Ponzi schemes. Most OTC derivatives operate wildly in off-shore financial havens across the world, avoiding regulation protections for investors, as EU Commissioner Barnier reported¹⁹. Only 10% of derivatives traded are standardized and traded on a Stock Exchange,; the remaining 90% are traded *Over the Counter (OTC)*, i.e. bilaterally and without control or supervision. At the end of 2009, the volume of OCT trade was around \$614 trillion (ten times global GDP of the world) (BIS 2010).

At the Macro Level: Prudential Supervision in the EU

The newly created European Systemic Risk Board (ESRB) will be at the center of the new system in the EU, although only with advisory functions²⁰ (see Figure A5 in the

¹⁶ The opposition to the EU finance regulation of the UK Parliament's Treasury Committee was immediately clear, and in an internal paper it suggested to the UK government to use their veto in the EU Council against it if the initial EU text would not be modified (UK Treasury Committee 2010:5).

¹⁷ They are a kind of insurance against credit default, but turned out to be speculative tools on the large scale, thanks to the mistaken evaluation of the CRA (2009a). During the financial crisis, the link between the initial credit and its securities derivatives was lost. Creditors could take more risks, because through CDS they could transfer the risk to somebody else. In the end, nobody knew how many CDS existed and where they were held. CDS were used massively to speculate against the Euro in the Greek crisis (Wahl, 2010).

¹⁸ Investors in Madoff's funds lost \$60 billion. In 2009, he was sentenced to 150 years in prison for defrauding investors through a massive Ponzi scheme.

¹⁹ EU Observer, 16.09.2010. <http://euobserver.com/19/30821>.

²⁰ The Steering Committee of the ESRB is composed of the seven European System of Central Banks (ESCB) members (including the President of the ECB), the three chairs of the European Supervisory Authorities, a member of the EU Commission, and the President of the Economic and Financial Committee. The General Board of ESRB comprises apart from the Steering Committee members all central bank governors of the EU 27.

Appendix). European Central Banks play a major role within this Board, helping to define, identify and prioritize all macro-financial risks. Macro-financial stability may need to be pursued through different means than the ECB's price stability objectives Smaghi (2009). This is a possible area of tension between the two institutions, and that is why the ECB, which prioritizes price stability, wants to maintain the leading role.²¹ The ESRB deals essentially with macro prudential supervision and reports to ECOFIN. It is also allowed to make warnings and recommendations directly to EU national governments.

5. Tensions, Vulnerabilities and Austerities among the US and EU

The regulatory overhauls passed after the crisis, both in the US and EU are different. The differences are just consequences of different perspectives on the crisis, which in turn underlines the different models in which the crisis simultaneously occurred: the ESM and the CME. These differences will likely bring about a new phase of post-financial crisis relations between the US and EU. In fact, the post financial crisis phase brought about both new and old disagreements between the EU and US. These disagreements reflect the basic differences between the economic systems of the EU and US. Varieties of capitalism and the different styles of market economy are issues which have already been explored in literature, as I mentioned earlier. This affects national problem solving and global answers to the crisis. Institutions are put in place by countries according to each one's own model of capitalism. Hence, finance and financial regulation is an institutional form which reflects a nation's individual economic model.

5.1 Tensions and differences between EU and US

²¹ The primary objective of the ESB is to maintain price stability. This is different from the mandate of the US central bank, as stated in its Statute: "Fed shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." For the ECB instead, the goal of economic growth secondary to inflation: "*Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.*" (Article 2 of ECB Statute).

The most important disagreement, both within the EU and on a global level, concerns a financial transaction tax (FTT). This is an old issue: the first to advance a proposal for a financial activity tax was James Tobin (1978). Now the issue has a twofold significance. First of all, the FTT would serve to finance the huge costs of this crisis. Since the financial sector bears much of the responsibility for this crisis, it is only fair, the advocates of the FTT say, that it pays for the societal costs. The expenditures of governments on stimulus programs to counter the crisis in the real economy was around 3.5% of global GDP. Along with the government money that went to rescuing banks, the total cost is €3.5 trillion at the global level (IMF, 2009a). Secondly, as in the original opinion of Tobin, it would regulate financial markets, limit speculation, and reduce short term and electronic financial activities, which have little to do with investment and saving operations. The FTT is discussed mostly in the EU, in particular among Eurozone nations, with Germany and France the principal supporters. The UK, US, and Canada strongly object it and the G20 Pittsburg meeting has already rejected it. Bank lobbies are strongly against the FTT, too. The Obama administration sees a potential compromise in a sort of Bank Levy, which would have a more modest impact on tax collection (\$14-19 billion in estimated revenues, against \$738 billion in revenues from the FTT)²². However, in the US many Congress members, in particular after the mid-term election of November 2010 was won by the Republicans, are strongly against a Bank Levy as well. An interesting proposal comes from the IMF, the Financial Activities Tax (FAT), which would tax the profits and remunerations of banks only (IMF, 2009a).

A controversial issue remains over the Basel agreements. On the eve of the financial crisis, the EU had just adopted (in 2006) Basel II, a set of rules regulating the capital requirements of banks, which were very flexible and favorable so that banks would agree to them. The new Basel agreement reached after the crisis (Basel III), in September of 2010, increases banks capital requirements, limits their liabilities and leverage ratios, and requires higher liquidity standards to meet customers' needs. Moreover, banks are required to fulfil the primary role in the game of securitization; holding higher shares of the securities in the credit risk products. Most importantly, a new definition of "capital" is introduced, according to which equity capital and disclosed

²² The estimate is done with a FTT at 0.1% and a medium reduction of the transaction volume per year (Schulmeister et al., 2008).

reserves only (i.e. liquid and own bank assets) are considered (see Table A4 in the Appendix). This improves the quality and consistency of capital and of leverage. However, while the EU will immediately adopt Basel III as it is suggested in an EU Parliament Proposal of 2010 (EU, 2010b), the US and UK are still devoted to a more flexible definition of capital and continue to refer to Basel II for guidance on most capital requirements. Moreover, the EU (with the exception of the UK) would support even higher standards, with capital requirements set at or near 10%.

Finally, another controversial issue is over Alternative Investments Funds (AIF). The EU recognizes that risks associated with AIF have been underestimated and are not sufficiently addressed by current rules. Many activities of large AIF, particularly those employing high levels of leverage, have greatly contributed to the current financial instability of the UE. Toxic assets related to AIF were implicated in the commodity price bubbles that developed in late 2007.²³ The new legislation tries to regulate not only AIF, but most importantly, AIF managers (AIFM) whose activities in their off-shore headquarters, on behalf of AIM, often avoid regulation. The new EU regulation on these matters is a good step forward (Wahn, 2010). However, the issue of AIF regulation in the EU is very complicated, in particular because of the UK opposition, in line with US position, which prefers to keep looser regulations and protect British interests: at the London stock exchange, 80% of all Hedge funds in the world operate, and the AIF's lobby is very strong. They do not like the idea of stricter supervision, disclosure of strategies, leverage limits, higher costs, or lower risks, which mean lower profits. Since the operational supervisors of the new authorities created by the EU remain at the national level, implementation can be difficult. Another issue of discordance within the EU, in particular between Germany and the UK, is the case of Credit Default Swaps (CDS). New EU regulations impose stricter supervision and introduce the right to ban short selling and the trade of CDS temporarily when it realizes that there is a speculation. Uncovered, or "naked," short selling is banned (European Council (2010). Such measures would have limited the severity of the Greek crisis in the spring 2010. The

²³ In its proposal, the EU acknowledges that AIF are covered by a lack of transparency when building stakes in listed companies, conflicts of interest, and failures in fund governance, in particular with respect to remuneration, valuation and administration, market abuse, misalignment of incentives in management of portfolio companies, weakness in internal risk management, inadequate investor disclosures, pro-cyclical impact of herding and risk concentrations, and direct exposure of systemically important banks (EU 2009c).

ESMA is the newly elected vigilance institution for that. Furthermore, requirements of transparency and information are required at the Stock Exchange where CDS are traded, and individual traders have to disclose their short positions over these assets.²⁴

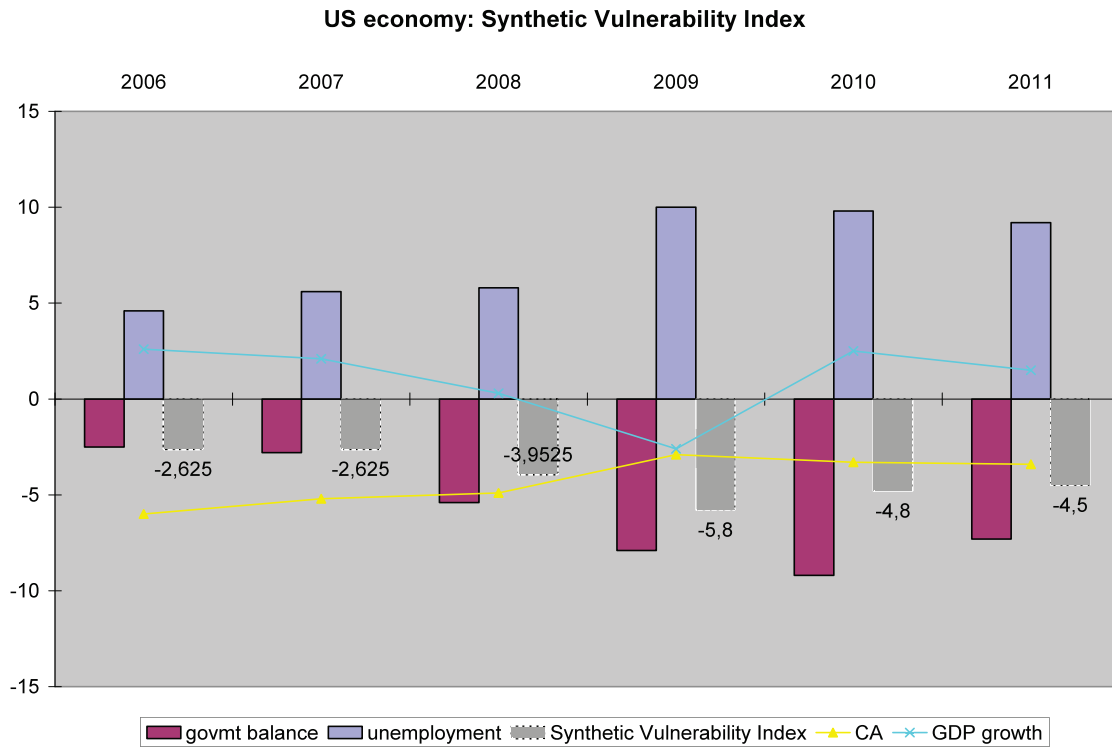
5.2 The Synthetic Vulnerability Index

These disagreements are crucial to the definition of new global financial governance, and show how deep the differences between the EU and the US and UK (and Anglo-Saxon countries in general) (Semmler and Young, 2010). Beyond these differences, and despite the attempts to reform the financial sector, finance and the economy at large still remain vulnerable, both in the EU and US. This is due to a combination of four indicators which are currently in dangerously vulnerable positions: 1) government deficits, 2) unemployment, 3) Current Account deficits (CA), and 4) slow recovery. The average of these four variables was calculated with the Synthetic Vulnerability Index (SVI)²⁵ in the figure below, for the Eurozone and US. From the SVI, the position of the US appears to be consistently weaker than that of the Eurozone (and in 2010 is -4.8 against -3.975) due in particular to higher government deficits and negative CA balance. Similarly in 2011. Moreover, the bilateral position of the EU-US, in terms of import-export merchandise and CA, shows a better position for the EU, in a constant surplus versus the US (see Figure A6 and A7 in the Appendix).

²⁴ The German regulation is even stricter on short selling because it bans speculation on falling prices, not only temporarily and in case of threats to stability. The German position is heavily criticized by the UK, which would prefer limited bans, or none at all.

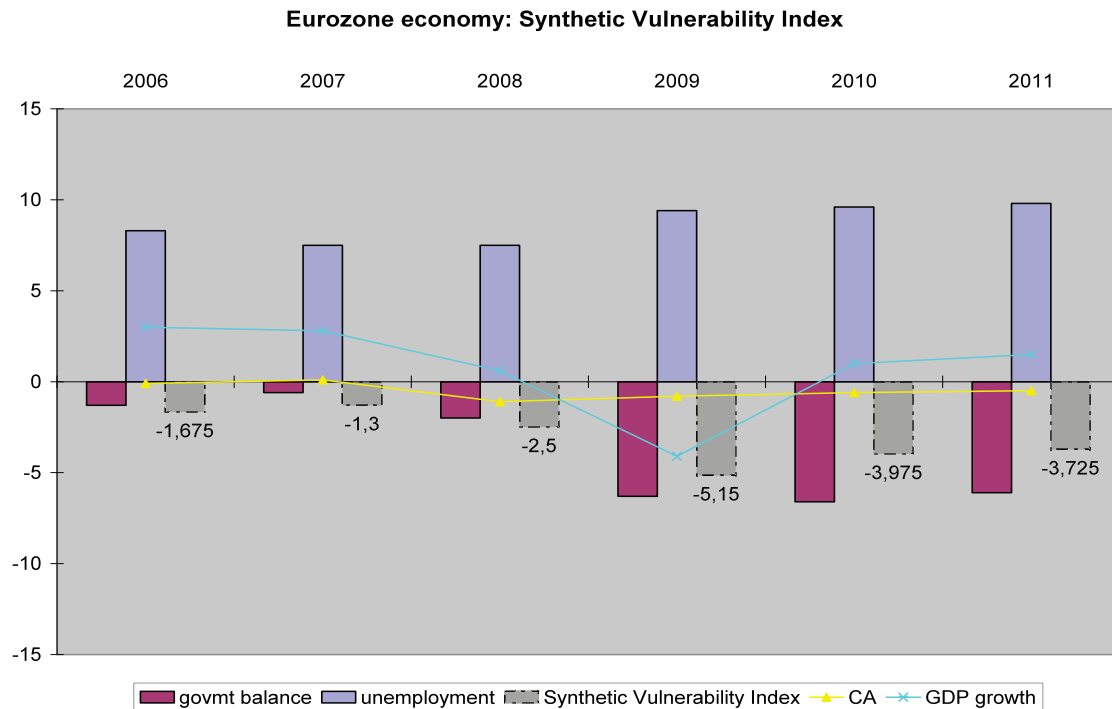
²⁵ The SVI is simply the arithmetic average of those 4 variables. The lower the worse. As regards Unemployment, which has normally a positive value, it was considered with the opposite sign in order to be consistent with the other variables.

Figure 4 - US Synthetic Vulnerability Index



Source: own elaboration on IMF, 2010 World Economic Outlook (online database)

Figure 4 – EU Synthetic Vulnerability Index



Source: own elaboration on IMF, 2010 World Economic Outlook (online database)

Beside that, another indicator supports the idea that the US is more vulnerable than the Eurozone, and in particular indicates that the US faces higher social costs. That is the recent evolution of the labor market indicators of employment and unemployment. Despite a lower recession in the US as compared to the Eurozone (-2.6% against -4.1%), in the US, the labour market was seriously affected by an unemployment rate which went from 4.6% to 9.8% (+5.2) and employment rate which fell from 72% to 64.5% (-7.5) in 2010 (see Figure A8 in the Appendix). The corresponding figures for the Eurozone look much better, with the unemployment rate rising from 8.6% to 9.6% (+1.2) and employment rate falling from 66.2% to 65.7% (-0.5%) (see Figure A9 in the Appendix). Obviously the role of Trade Unions, traditionally stronger in Europe (Nickell, 1997), has been crucial in protecting employment during the recession; beside, the unemployment elasticity to GDP changes seem to be much lower in the EU than in the US. Moreover, the GDP changes (and recovery) in the US seem to be seriously affected by structural problems which shape negatively income distribution and favors mostly the financial sector, which are continuously compensated with short-term finance bonus biases (which do not find any theoretical justification). Wage shares on GDP continue to decline during the crisis, as showed in the figure 2 above in section 3. Moreover, such a growth seems to be driven mostly by consumption components, which in turn are sustained by the credit. This kind of growth is uneven, unstable and more inclined to generate bubble and burst cycles. It is far from what the International Monetary Fund and the World Bank define “high-quality growth” (HQG). In particular, the IMF defines HQG as “...growth that is sustainable brings lasting gains in employment and living standards, reduce poverty and inequality (IMF 1995: 286).

Finally, given the relatively lower percentage of US public expenditure directed towards unemployment policies (0.49% of GDP against the 2.8% of GDP countries on the Eurozone spent), the human cost of unemployment is much higher in the US than the Eurozone (see figure A10 in appendix). All this confirms my argument that the ESM (roughly the Eurozone) is better able to cope with this crisis, allowing fewer social costs and creating better social performance than see in US.

Yet the EU faces a major issue, which US does not have, i.e., the Euro situation and the contradiction of the European Monetary Union (EMU), having a common monetary policy, without: 1) a central budget, 2) a common fiscal policy and, 3) a de-

facto, no labor mobility within the Eurozone. Quite the opposite, the US dollar, the federal budget and a labor mobility within US are the main strengths of American economy *vis à vis* the EMU. The European common currency paradoxically, but perhaps not surprisingly, has divided the EU between core and periphery. This division could be accepted and somehow managed, however it needs to be backed by political decisions which introduce wider common fiscal policies and a central budget (a central budget of around 1% of EU GDP as today, is unacceptably low). It follows that EU imbalances should be treated as an internal issues, managed through Euro-Bonds, ECB policy of buying member state Bonds, and a permanent European Fund such as the Financial Stability Facility which could contribute to manage EU aggregate demand and could work (if not the ECB) as a lender of last resort. In this sense, the Tremonti-Junker proposal of issuing European Union Bonds would go in the right direction²⁶.

5. 3 *The return of austerity*

In order to recover from the crisis, governments initially put in place fiscal stimuli and bank rescue packages (see table below). These policies were supported by a great consensus among the policymakers, politicians, and academics who had begun to look at Keynesian policies in a favourable way. In the US under the Bush administration the TARP (Troubled Asset Relief Program) Act was launched in order to purchase “troubled” assets and equity from financial institutions and to strengthen trust in the financial sector. The Act allowed the Treasury to purchase illiquid, difficult-to-value assets from banks and other financial institutions as a first reaction to the subprime mortgage crisis, for a value of 700 US bn \$ (or 2.3 of US GDP). This was followed by Obama’s fiscal stimulus, known as ARRA (American Recovering and Reinvestment Act) which entered onto the scene in February, 2009 for a value of 775 US bn \$ (or 2.7 of US GDP). The stimulus aims to promote, in the Keynesian tradition, job creation, investment, and consumer spending during the recession for a value of (Romer and

²⁶ Jean-Claude Juncker and Giulio Tremonti made a proposal on the Financial Times for a European Union bond, issued by a European Debt Agency (EDA). Each country can issue European bonds up to 40% of GDP. This would create, over time, a sovereign bond market of similar size to the US one. Initially the EDA would finance 50% of member states’ debt issues – but this can be raised to 100% during crises. The proposal also envisions a mechanism to switch between national and European bonds for countries in trouble at a discount rate. This would avoid the problem that secondary markets in many EU sovereign bonds are not sufficient liquid during crises.

Bernstein, 2010). In the main EU countries fiscal stimuli were implemented to, for a total around 300 US bn \$ (or 1.5% of EU GDP) (IMF 2009b).

The outcomes of these stimuli were quite positive: in the second quarter of 2010, Germany grew at an extraordinary rate of 8.8%, and the UK at 4.8%. Similar stories, although of less magnitude, occurred in other European economies. The US recovered, too, with 1.6% growth for the same period. Nevertheless, after the spring of 2010, policy consensus switched towards austerity measures. After the Greek crisis, governments turned their interests, irrationally, toward budget cuts and policies of contraction (Arestis and Pelagidis, 2010). In the fall of 2010, the new Liberal-Conservative government in the UK announced an austerity plan with cuts in public expenditures and a freezing of public employment wages and jobs for the next three years. A similar plan was announced in the US by President Barack Obama in November, 2010, freezing federal pay for the next two years. Chancellor Merkel is proposing similar restrictive plans in Germany, and other continental European countries are preparing financial laws very much focused on restrictive fiscal measurements. The objective is to reduce deficits. This seems more like a reaction to the Greek and Irish crises, rather than a rational decision which would help economic recovery (Arestis and Pelagidis, 2010).

6. Conclusion

In the same vein as Kindleberger (2005), we can conclude that if there are manias governing financial systems, which are far from rational and efficient, then governments should intervene and regulate. Monetary policy could go further to discourage manias by implementing a financial transaction tax. Beyond that, however, governments need to do something more: guarantee an appropriate level of consumption which could be sustained by an appropriate level of wage in order to maintain an appropriate level of aggregate demand. Finance, regulated under the supervision of the state, should serve productive investments. On the other side, an appropriate level of aggregate demand is guaranteed by a demand management policy which relies on an appropriate level of public investment. However the most recent austerity policies, both in Europe and the US, go just in the opposite direction (Arestis and Pelagidis, 2010)

Lessons can be drawn, obviously, from Keynes and from the Fordist model of production, where finance had a secondary role in the economic system and it was a tool

which guaranteed credit for firms and productive investments, while wage, which guaranteed consumption, was the main nexus around which other institutional forms gravitated. The Eurozone today looks to be in a slightly better position than the US, as the Synthetic Vulnerability Index showed. This is also due to the fact that the institutional forms are a bit more anchored to the wage nexus, unemployment does not increase dramatically as in the US during crisis, and finance is not yet the main institutional form, although the past twenty years in Europe have seen deregulation of finance and liberalization which brought about strong financialization in the economic system and greater systemic risk. The Eurozone, and in particular the countries of the ESM, are able to combine, better than the US, efficiency (GDP growth) and social performance (inequality, poverty, mass education and life expectancy). After the WWII the countries of the Eurozone grew faster than the US and reached better social conditions. Only in the last two decades has the US had slightly faster GDP growth, with further worsening social indicators. However, that GDP growth in the US was led by the kind of financialization which caused the big crash and the Great recession of 2007-2009. In this light, the US model, led by finance, raises many doubts and should be radically reformed. I suggested this has to be done along the lines of the ESM. Despite the fact that GDP recession was deeper in the EU than in the US, and GDP recovery seems to be faster in the US, social costs are greater than in the EU. As we argued in section 5.2, the US recovery seems still be affected by structural problems of income distribution, consumption-driven components and huge compensation in the financial sector. This in the end will generate an unstable economic growth which favours again the top decil of the income distribution and which is keen to cause bubble and burst cycles.

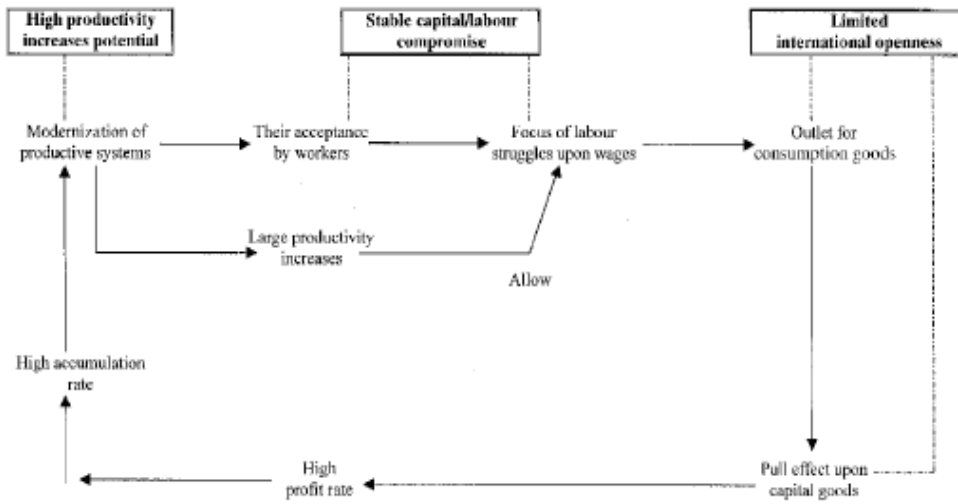
Finally, the EU and US efforts toward financial regulation have to be welcomed, although they still seems insufficient to bring the whole system to a path of stable and sustainable development. In the US, the Frank-Dodd Act is an inferior compromise which would need to be improved in order to give real stability to the system and eliminate, or simply reduce, the systemic risk. Too many carve-outs and ambiguities remain, in particular regarding the oversight role of the Fed towards large firms, the almost unchanged regulation for Rating Agencies and hedge funds, the objections against a financial tax, and the opposition to Basel III. Though it does seem interesting the introduction of the Volcker rule, which separates the dangerous coexistence between

investment and commercial banks and limits banks in engaging proprietary trading, occurred in the US.

In Europe, the main difficulties are at the operational level of the new EU financial regulatory systems introduced. Too much fragmentation exists among members states, divisions between Eurozone and non Eurozone, and most importantly, a very different strategic position between the French-German axe and the British. Such strategic differences pose obstacles to the very important questions, such as a financial transaction tax, hedge fund regulation, and the introduction of a sort of Volcker rule. Not to mention the differences over the general framework of the kind of the socio-economic model required. Financial stability, financial integration, and national supervisory autonomy cannot be achieved simultaneously. The EU must decide what it wants to achieve, knowing that only two out of those three objectives can be achieved simultaneously.

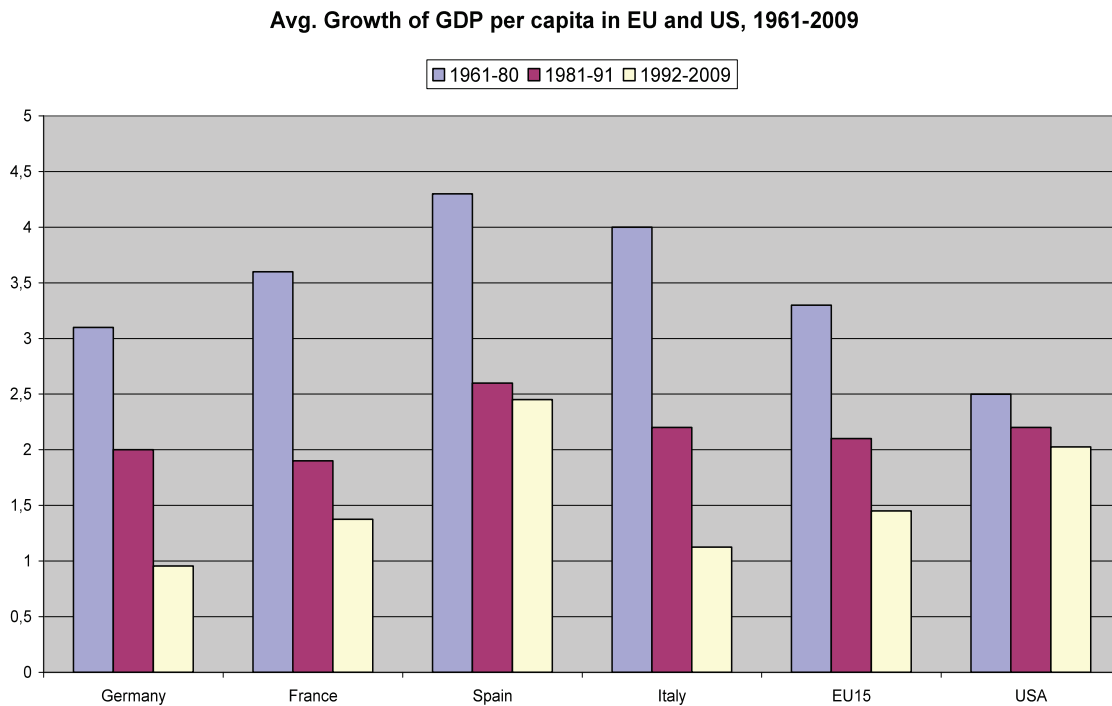
APPENDIX

Figure A1 – The Mechanism of the Fordist Growth Model



Source: Boyer, 2000

Figure A2 - GDP Growth in the EU and the US



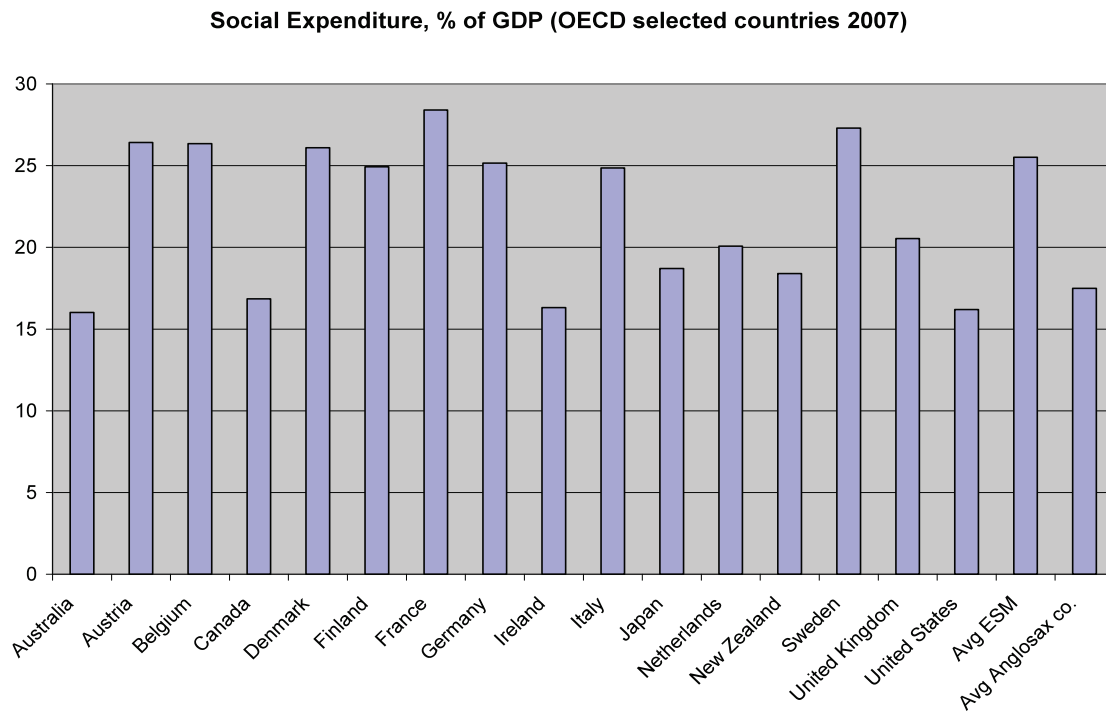
Source: Eurostat

Table A1 - US and Eurozone Comparison on Main Features

	Eurozone 2009	US 2009
World share of GDP	14.8% (EU27: 21%)	20.2%
Global market share in terms of exports (world %)	15% (EU27: 20%)	13%
Population	328 mln: (EU 27: 498mln)	317mln
Inequality - Gini coefficient	0.29%	41%
GDP per capita \$ ppp	33,452	46,653
Life expectancy at birth	81	79
Poverty (50% of median income) 2006	10%	17.1%
Combined gross enrolment ratio in education (primary, secondary & tertiary levels, % of pop)	95%	92%
Secondary enrolment ratio (% of secondary school-age population)	91%	88%
Primary enrolment ratio (% of primary school-age population)	97%	91%
Expected years of schooling (children)	16	15

Source: IMF, 2010 World Economic Outlook (online database), UNDP (HD Report, online database)

Figure A3 - EU and US Social Expenditures



Source: OECD 2010, Employment Outlook (online database)

Table A2 – Varieties of Capitalism

Varieties of capitalism within the enlarged European Union (17 Eurozone members, with *)			Competitive Market Economies (Anglo-Saxon model)
European Social model: Austria* Belgium* Finland* France* German* Netherlands* Slovenia* Denmark Sweden Luxemburg* Hungary Czech Rep Greece* Italy* Portugal* Spain*	Hybrid model (mixed between ESM and LME) Cyprus* Malta* Latvia Lithuania Poland Romania Bulgaria Estonia* Slovakia*	Competitive Market Economies (CME) UK Ireland*	US, UK, Ireland, Canada, New Zealand, Australia

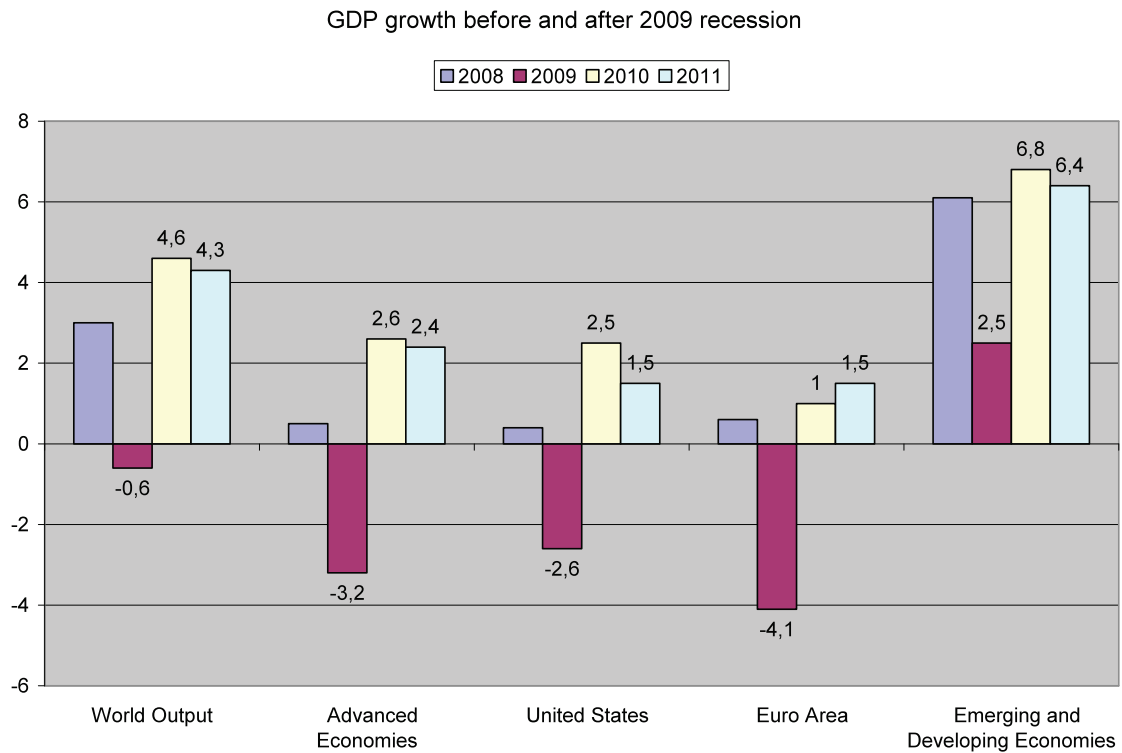
Note: Norway and Switzerland are not part of the EU but would fit very well in the ESM (Pontusson 2005). Greece, Italy, Portugal and Spain sometimes classified as Mediterranean model with typical characteristics of the ESM such as consistent Welfare States and Public expenditure, coupled with inefficiency, debt and corruption (which usually are not found in the ESM). Source: adapted from Pontusson (2005), Tridico (2011)

Table A3 – Main Macroeconomic Variables for the US and Eurozone (EU-16)

	2006		2007		2008		2009		2010		2011	
	US	EU16	US	EU16	US	EU16	US	EU16	US	EU16	US	EU16
GDP (% annual change)	2.6	3.0	2.1	2.8	0.3	0.6	-2.6	-4.1	2.5	1	1.5	1.5
Unemployment (% of the labour force)	4,6	8.3	4,6	7.5	5,81	7.5	10	9.4	9.8	9.6	9.7	9.8
Inflation (HICP nom. change)	3.2	2.2	2.8	2.1	3.8	3.3	0	0.3	2	1.5	2.7	1.7
Government balance(% GDP)	-2,5	-1.3	-2,8	-0.6	-5,4	-2.0	-7,9	-6.3	-9,2	-6.6	-7,3	-6.1
Government debt (% GDP)	61,1	68.3	62,1	66.0	70,6	69.4	83,2	78.7	92,6	84.7	97,4	88.5
Current a/c balance(% GDP)	-6	-0.1	-5,2	0.1	-4,9	-1.1	-2,9	-0.8	-3,3	-0.6	-3,4	-0.5
Central Bank/Fed main interest rates	4.25	2.25	5.25	3.5	2	4	1	2.5	0.25	1		
Exchange rate 1 Euro over \$	1.25\$		1.34\$		1.36\$ (max 1.59\$ July 2008)		1.40\$		1.30% (min. 1.19 June 2010)			

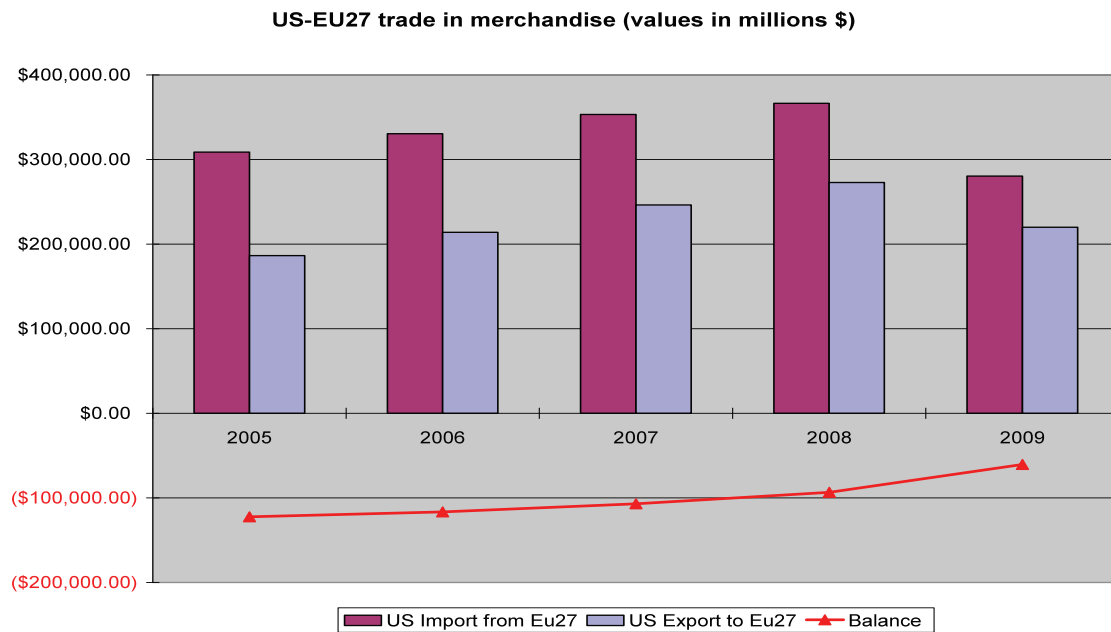
Source: IMF, 2010 World Economic Outlook (online database), OECD Employment outlook (online database), Fed Statistics (online database), ECB (2010)

Figure A4 – The 2008-09 Recession and Projections



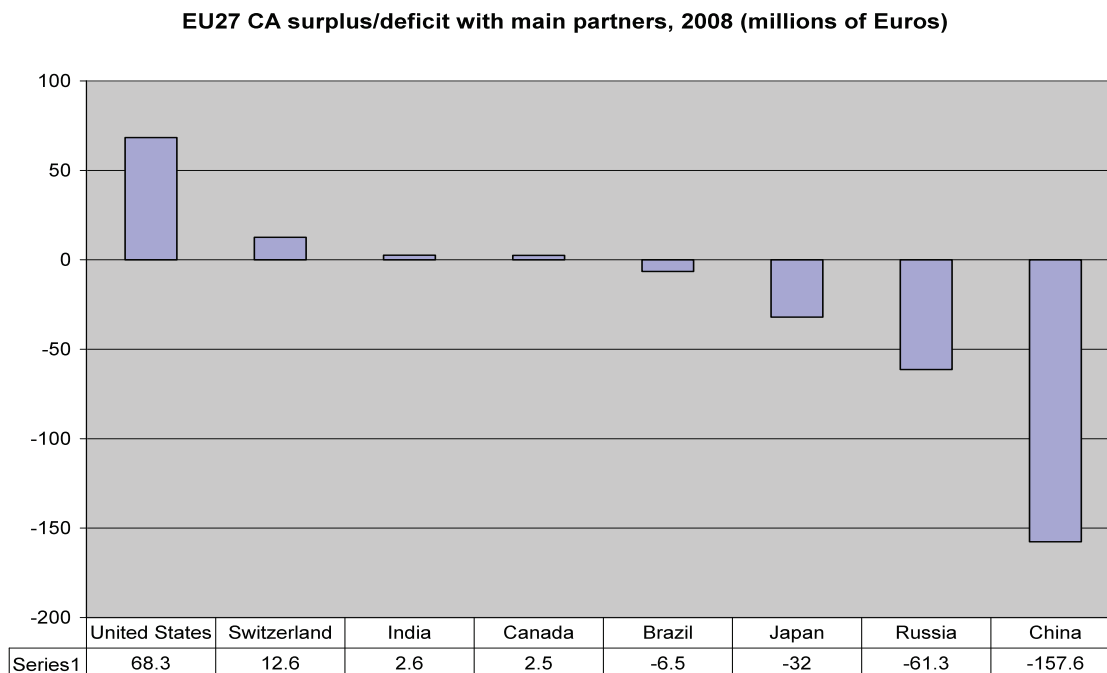
Source: IMF, 2010 World Economic Outlook (online database)

Figure A6 - US-EU27 Trade Balance



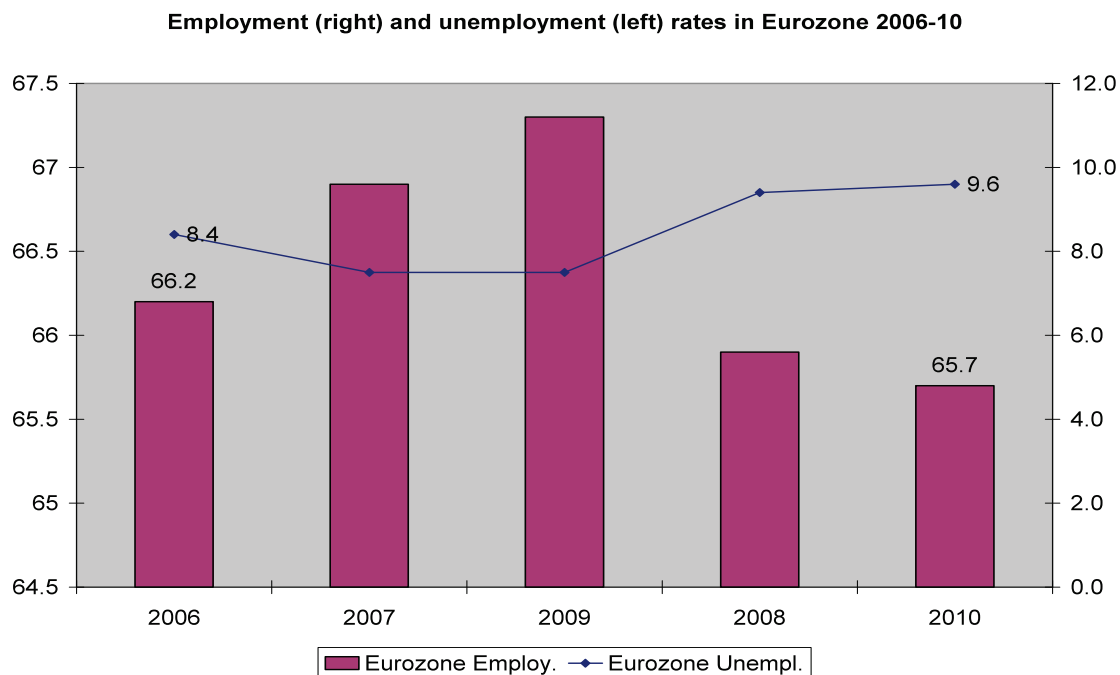
Source: US International Trade Commission, online database, 2010

Figure A7 – EU Current Account Balance with Selected Partners



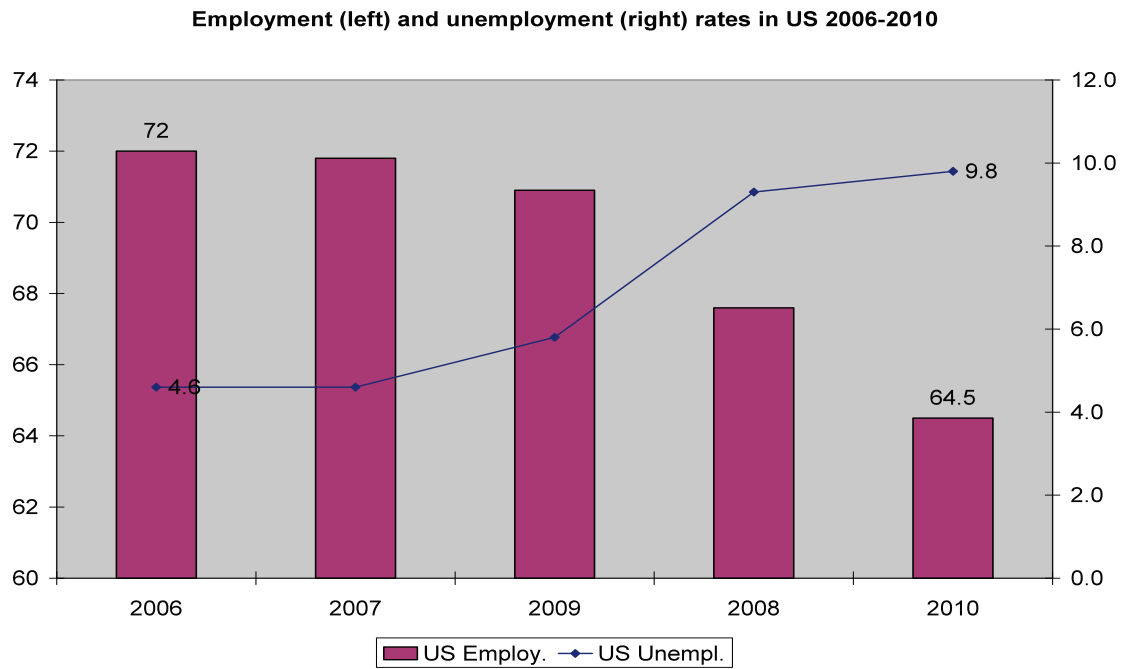
Source: Eurostat

Figure A8 – Labour Market Evolution in the Eurozone



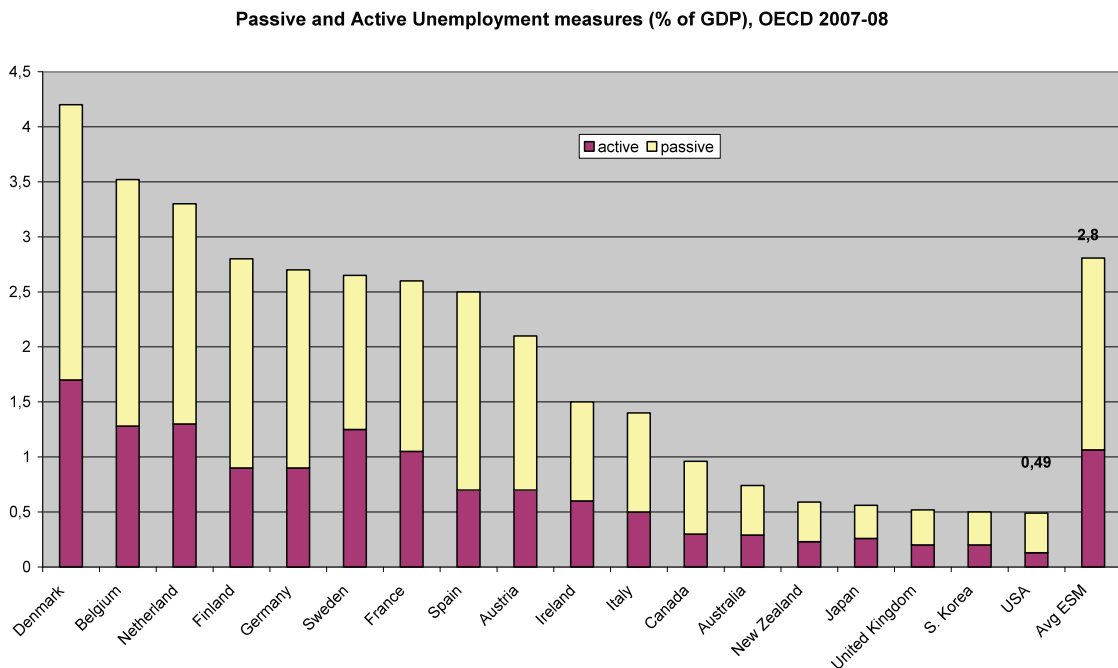
Source: Eurostat

Figure A9 – Labour Market Evolution in the US



Source: US Bureau of Labour Statistics

Figure A10 – Public Expenditure on Unemployment, OECD Countries



Source: OECD 2010, Employment outlook (online database)

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